More details on US banking failures

Nick Beams
16 October 2023

The report by the Basel Committee on Banking Supervision, published by the Bank for International Settlements earlier this month, provides further insight into the conditions which led to the March-April episode of significant US and global banking stress.

It pointed to large-scale deficiencies in the management practices of the banks involved, a culture of profit-making at all costs without regard to the risks involved, lack of supervision by regulatory authorities because they lacked the resources and, in cases where it was carried out, manifest failures of assessment.

The report began by noting that the turmoil in the banking system was "the most significant system-wide banking stress since the Great Financial Crisis (GFC) in terms of scale and scope."

The report did not make the point, but it was the occasion for three of the four largest bank failures in US history.

However, it did note that the failures of Silicon Valley Bank, Signature Bank and First Republic "triggered a crisis of confidence in the resilience of banks, banking systems and financial markets across multiple jurisdictions" and that "wide-scale public support measures" were necessary to mitigate the impact of the stress.

This is a rather euphemistic way of saying that regulatory measures put in place after the crisis of 2008, which were supposed to guard against the necessity of state intervention, failed completely. Once again a bailout operation had to be launched lest there was a "systemic" breakdown.

The report claimed that what are known as the Basel III reforms have "helped to shield the global banking system from a more severe banking crisis" but goes on to say they "are not calibrated to produce 'zero failures.'"

It is not clear from the report what exactly the reforms are intended to do because it pointed out that "despite the enhanced levels of resilience provided by Basel III, the recent turmoil highlighted that banks can be vulnerable to rapid changes in market sentiment."

However, it is precisely in conditions of "rapid changes" in market sentiment that regulations are supposed to have their effect. If they do not, then it is akin to having an umbrella that works well in relatively calm conditions but is blown inside out and rendered useless in a storm.

Furthermore, according to the report: "The combination of high leverage and long-term opaque assets that are funded with short-term runnable deposits makes banks especially vulnerable to a loss of trust in their long-term solvency."

The situation described is not an exceptional set of circumstances. It is at the very centre of banking operations and profit making from time immemorial—borrowing short term and lending long. What makes the present situation so potentially explosive is that in the financial world today these operations have assumed ever larger and more complex forms.

The report outlined three structural changes that have taken place since the 2008 crisis. Non-banking financial intermediation, in particular the role of hedge funds, "grew significantly" and now accounts for around 50 percent of global financial assets.

A crypto asset system has rapidly developed, accounting for nearly $3 trillion in 2021 before falling back to $1 trillion. While the connection to the global banking system is small overall, crypto assets "are concentrated in a small number of banks."

Thirdly, the digitalisation of finance and the use of mobile apps facilitates the ability of depositors to rapidly move their funds.

The report provided some details about each of the banks that went down. Between 2019 and 2021, Silicon Valley Bank (SVB) tripled in size "as it benefited from rapid deposit inflow during the period of rapid venture capital and technology sector growth in a period of exceptionally low interest rates."

These deposits, largely uninsured, were invested by SVB in long-term Treasuries, which led to a rapid increase in unrealised losses when their value fell as a result of higher interest rates.

On March 9 SVB lost over $40 billion in deposits. It was set to lose $100 billion the following day in a deposit outflow that was "remarkable in terms of scale and scope when compared with other episodes of banking stress."

The SVB board put short-run profits above effective risk management and removed interest rate hedges that would

© World Socialist Web Site

have protected the bank. Moreover, it had compensation packages for senior management which provided an incentive to focus on quick profits.

The failure of Signature Bank, which had total assets of $110.4 billion and was third largest bank failure in US history, raised other significant issues. Like SVB, it experienced tremendous growth with its size doubling during 2020–2021.

The trigger for its failure was the self-liquidation of Silvergate Bank, which was heavily involved in crypto currency, as well as the flow-on effect from the demise of SVB. The report said the failure of the bank was due to poor management and its failure to understand the risks associated with its heavy involvement in the crypto market.

However, the report issued a mild rebuke to the Federal Deposit Insurance Corporation (FDIC) saying it could have escalated supervisory actions sooner and its communications with the bank's management "could have been more effective."

But perhaps the most significant comment dealt with the capacity of the FDIC. One might have thought that following the 2008 global financial crisis and the outlay of billions of dollars to rescue the banks, resources would have been pumped into the regulatory bodies. Not so.

"The FDIC experienced resource challenges with examination staff that affected the timeliness and quality" of examinations. From 2017 to 2023, the FDIC was not able to adequately staff an examination team for the bank. Certain targeted reviews "were not completed in a timely manner or at all because of resource shortages."

Even where reviews were carried out, they were not just useless, but presented a false picture. The New York Regional Office of the FDIC gave Signature a rating in March, on the eve of its collapse, indicating the overall condition of the bank was satisfactory. It rated the board's performance as satisfactory right up until March 11, the day before the bank was closed.

The report found that with the failure of SVB and Signature the market turned to the next weakest link and found it to be Credit Suisse (CS) . It was taken over by Swiss authorities after "it became clear CS would not have been able to regain market and client confidence" and was "fast approaching a point of non-viability due to massive cumulative liquidity outflows and its increasing difficulties to transact with other market participants."

The wind up of First Republic was somewhat more protracted but it eventually went down in May for essentially the same reasons as the other two US banks.

Throughout its report, the Committee continually referred to the failed banks as having "outlier business models." Such a description is intended to create the impression that the failures have no broader significance. It makes one wonder whether the supposed regulatory authorities have any idea of the working of the financial system over which they supposedly preside.

The very nature of the capitalist system, and above all finance capital, is to develop new "outlier" models which make profit above the market rate. The development of such methods, which become the norm, gives rise to the development of new and more risky methods in the pursuit of profit.

The report cast doubt on the efficacy of its methods. It said a rules-based approach to regulation typically set minimum standards which trigger action when they are breached. Such a system assumes a base level of commonalities in business models and risks.

"But it can also overlook the unique risks associated the novel/outlier business models as well as any technological developments in doing so." As a result, it "can provide false comfort to supervisors and the public that risks are appropriately assessed and disempower supervisors to engage with banks under a regulatory trigger is exercised, which may often be too late."

It further noted that the law may prevent supervisors taking action "even though the authority may have identified risks that could threaten the bank's safety and soundness." This can occur because they do not have a legal basis for doing so until a regulation is breached.

The report did not mention it, but banks and financial institutions have batteries of lawyers on hand whose task it is to develop schemes to get around existing regulations as this is the road to greater profit.

Providing only a limited view of the events of last March, the report did, however, give a glimpse of the highly unstable nature of the entire financial system and the inherent impossibility of any meaningful control and regulation of its explosive contradictions.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site